STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of Mix 'N' Match of Miami, Inc.	AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision of a Determination or Refund of Corporation Franchise Tax under Article 9A of the Tax Law for the Fiscal Years Ended 1/31/79 & 1/31/80.	

State of New York :
ss.:
County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 18th day of January, 1985, he served the within notice of Decision by certified mail upon Mix 'N' Match of Miami, Inc., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Mix 'N' Match of Miami, Inc.
112 W. 34th St.
New York, NY 10001

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
18th day of January, 1985.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of Mix 'N' Match of Miami, Inc.	AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision of a Determination or Refund of Corporation Franchise Tax under Article 9A of the Tax Law for the Fiscal Years Ended 1/31/79 & 1/31/80.	

State of New York :
ss.:
County of Albany :

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 18th day of January, 1985, he served the within notice of Decision by certified mail upon Harry Wasserman, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Harry Wasserman
Weinick, Sanders & Co.
1515 Broadway
New York, NY 10036

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
18th day of January, 1985.

David Parchuck

Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of MIX 'N' MATCH OF MIAMI, INC. for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended January 31, 1979 and January 31, 1980.	DECISION

Petitioner, Mix 'N' Match of Miami, Inc., 112 West 34th Street, New York, New York 10001 filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended January 31, 1979 and January 31, 1980 (File No. 35629).

A formal hearing was held before Daniel J. Ranalli, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on April 26, 1984 at 9:15 A.M., with all briefs to be submitted by August 1, 1984. Petitioner appeared by Harry Wasserman, C.P.A. The Audit Division appeared by John P. Dugan, Esq. (Paul Lefebvre, Esq. of counsel).

ISSUES

I. Whether petitioner was required to add back 90 percent of its federal deduction for interest paid on indebtedness to a shareholder owning more than 5 percent of petitioner's issued capital stock.

II. Whether petitioner was required to include a portion of the wages of employees of a sister corporation in the payroll factor of its business allocation percentage where petitioner reimbursed its sister corporation for certain sales services provided by employees of the sister corporation.

FINDINGS OF FACT

1. Petitioner, Mix 'N' Match of Miami, Inc., filed New York State corporation franchise tax reports for fiscal years ended January 31, 1979 and January 31, 1980.

2. On October 14, 1981, as the result of a field audit, the Audit Division issued a Notice of Deficiency pursuant to Article 9-A of the Tax Law against petitioner in the amount of $5,385.00, plus interest of $1,222.00, for a total due of $6,607.00 for the fiscal year ended January 31, 1979. On the same date, the Audit Division issued a Notice of Deficiency against petitioner in the amount of $9,481.00, plus $1,345.00 in interest, for a total due of $10,826.00 for the fiscal year ended January 31, 1980.

3. On audit, the auditor determined that petitioner should have added back to its entire net income 90 percent of interest payments made to its corporate shareholder and deducted on its Federal return. Additionally, the auditor determined that reimbursements for salesmen's services provided to petitioner at its New York office should have been included in computing petitioner's business allocation percentage. For the fiscal year ended January 31, 1979, the auditor increased the business allocation percentage from 5.7882 percent to 25.9716 percent. For the fiscal year ended January 31, 1980, the auditor increased the percentage from 7.1541 percent to 30.5197 percent.

4. Petitioner is a subsidiary of Roanna Togs, Inc. ("Roanna"). Lassie Togs, Inc. ("Lassie") and Louisa Manufacturing Corp. ("Louisa") are also subsidiaries of Roanna. The officers of all the related corporations are the same individuals. Roanna is a holding company which conducts no operations, has no employees and maintains a zero profit and loss balance on its books. Louisa is involved in manufacturing apparel which is then sold by petitioner

and Lassie. Lassie sells children's clothing ranging in size from infant to size two. Petitioner sells children's separates that can be mixed and matched and range from size four through size six. During the years in issue, petitioner's annual sales were approximately two to three million dollars and Lassie's sales were approximately seven to eight million dollars.

5. Periodically, petitioner found it necessary to borrow money to meet current expenses and make seasonal purchases. Whenever petitioner needed a loan, Roanna would borrow the money from a bank and then relend the money to petitioner. This procedure was followed because Roanna had previously set up cross corporate guarantees and various types of legal documentation with the bank to establish an efficient lending mechanism. The bank would have been willing to lend the money directly to petitioner; however, for the sake of convenience and efficiency, Roanna did the borrowing and acted as a conduit for the borrowed funds. The bank discounted all its loans to Roanna; that is, the bank charged the interest on the loans in advance and credited Roanna with the net amount. Roanna passed the net amount through to petitioner and charged the discount amount to petitioner which repaid the discount charge to Roanna so that Roanna could maintain its zero profit and loss balance. The discount charge paid to Roanna was taken as a deduction on petitioner's Federal corporation tax return for each of the years in issue. Petitioner did not add back 90 percent of such interest payments to its entire net income since it was merely using Roanna as a conduit for transfer of the borrowed funds. Petitioner was not undercapitalized when it received the loans and the bank was not an entity related to either Roanna or petitioner. The loans were carried on Roanna's books as loans receivable from petitioner and were carried on petitioner's books as loans payable.

6. During the years in issue, petitioner maintained no showrooms for its apparel line and had no employees other than a warehouse manager in Florida for a portion of 1978. Lassie maintained a showroom in New York City and incurred all expenses connected with its operation. Lassie also employed its own sales personnel. All of the sales personnel at the New York showroom were employed by Lassie and were enrolled in Lassie's pension plan. Lassie withheld all federal and state taxes and paid social security and unemployment insurance for the salespersons. Lassie's vice president for sales, Harold Maslin, supervised the sales personnel at the New York showroom. Virtually all of Lassie's and petitioner's sales were conducted with customers who visted the showroom. When a customer wished to see petitioner's line of apparel, Mr. Maslin would direct several of Lassie's salespersons to show the clothing to the customer. Three salesmen, in particular, were utilized for this purpose when required. Generally, the salesmen spent 70 percent of their time showing the Lassie line and 30 percent showing petitioner's line.

7. Petitioner reimbursed Lassie for the use of Lassie's salesmen. This reimbursement was accomplished in the form of an annual bookkeeping adjustment made while preparing financial statements for the corporations. The tax returns of petitioner, Lassie and Roanna were prepared based on the financial statements. According to the financial statements, Roanna reported no salaries and Lassie reported 100 percent of the wages paid to all of its employees. The controller, who prepared the financial statments, did not prepare the tax returns; however, he explained that the information reported on both the statements and the returns should have been the same. The allocation factor would affect only petitioner since both Roanna and Lassie allocated 100 percent of their income to New York.

CONCLUSIONS OF LAW

A. That section 208.9(b)(5) of the Tax Law provides, in pertinent part:

"(b) Entire net income shall be determined without the exclusion, deduction or credit of:

* * *

(5) ninety per centum of interest on indebtedness directly or indirectly owed to any stockholder or shareholder (including a subsidiary of corporate stockholder or shareholder), or members of the immediate family of an individual stockholder or shareholder, owning in the aggregate in excess of five per centum of the issued capital stock of the taxpayer, except that such interest may, in any event, be deducted

(i) up to an amount not exceeding one thousand dollars,

(ii) in full to the extent that it relates to bonds or other evidences of indebtedness issued, with stock, pursuant to a bona fide plan of reorganization, to persons who, prior to such reorganization, were bona fide creditors of the corporation or its predecessors, but were not stockholders or shareholders thereof,

(iii) in full where the investment allocation percentage is applied to entire net income, and

(iv) in full to the extent that it is paid to a federally licensed small business investment company;...".

B. That the modification set forth in section 208.9(b)(5) disallows 90 percent of a corporation's Federal deduction for interest paid or accrued on indebtedness to a shareholder owning more than 5 percent of the stock of the taxpayer. The only exceptions to this modification are those situations provided for in clauses (i) through (iv) of section 208.9(b)(5). Nowhere in the law or regulations is there a provision for an exception to the aforesaid modification for a corporate stockholder which borrows money and acts as a conduit in relending the money to its subsidiary. The Audit Division, however, has, for a number of years, been following a policy whereby, under certain conditions, if a stockholder of a corporation borrows money from an unrelated source, and then lends the borrowed funds to such corporation, the interest paid to such stockholder by the corporation is deemed to have actually been paid to the stockholder merely as a conduit, and the provisions of section

208.9(b)(5) are not applicable to such interest. Such an exception to the inclusion of interest has been allowed when the "pass-through" structure of the loan was established for reasonable business purposes and under certain conditions such as the lender being unrelated to the stockholder or the corporation (see, e.g., MC Minerals Corporation, Advisory Opinion, March 27, 1981 [TSB-H-81(21)C]; Kowa Realty (America), Ltd., Advisory Opinion, December 9, 1981 [TSB-A-81(9)C]) (enunciating Audit Division policy with respect to conduit theory).

In accordance with the correct interpretation of the statute, the Audit Division has, since January 1, 1984, discontinued recognition of the conduit theory. Inasmuch as petitioner and numerous other corporations have structured their loan arrangements to comply with established Audit Division policy, the exclusion of interest paid by a corporation to its stockholder will be permitted with respect to payments of interest made or accrued (where the taxpayer is on an accrual basis) prior to January 1, 1984 when a taxpayer has claimed pass-through on its return by refraining from making an add-back under section 208.9(b)(5) and at the time of the loan which generated the interest payments in question satisfied the standards required by prior Audit Division policy.

C. That the loan arrangement established by Roanna with respect to loans passed through to petitioner met the criteria for a valid application of the conduit theory and the interest payments were made prior to January 1, 1984; therefore, 90 percent of the interest paid by petitioner to Roanna on loans obtained by Roanna and reloaned to petitioner were not required to be added back to petitioner's federal taxable income to determine New York entire net income.

D. That section 210.3 of the Tax Law provides that entire net income may be allocated within New York State by multiplying business income by a business allocation percentage, investment income by an investment allocation percentage, and by adding the products so obtained. The business allocation percentage is determined by a three-factor formula comprised of a property factor, a receipts factor weighted as two, and a payroll factor. The payroll factor is determined by:

> "ascertaining the percentage of the total wages, salaries and other personal service compensation, similarly computed, during such period of employees within the state, except general executive officers, to the total wages, salaries and other personal service compensation, similarly computed, during such period of all the taxpayer's employees within and without the state, except general executive officers;...".

E. That 20 NYCRR 4-5.2(b) provides that:

> "[g]enerally, the relationship of employer and employee exists when the taxpayer has the right to control and direct the individual not only as to the result to be accomplished by him but also as to the means by which such result is to be accomplished. If the relationship of employer and employee exists, the designation or description of the relationship, and the measure, method or designation of the compensation are immaterial."

F. That in directing certain of its employees to occasionally show the Mix 'N' Match line, Lassie did not relinquish the right to control and direct the salespersons to the extent that an employer-employee relationship was established between petitioner and the salespersons. There was no direct supervision by petitioner nor was there any defined time period during which the three salesmen provided services for petitioner. If a customer was on the premises to look at the Lassie line and also wished to see the Mix 'N' Match line, the salesman would show both while still under the direction and control of Lassie. The salesman would not stop showing the Lassie line and become an exclusive employee of petitioner to show its line. The showing of the lines was intertwined and ultimate direction and control rested with Lassie. Therefore,

petitioner properly reported its payroll factor as zero during the years in issue (see Matter of House of Ronnie, Inc., State Tax Commission, January 20, 1984).

G. That the petition of Mix 'N' Match of Miami, Inc. is granted and the Audit Division is directed to modify the notices of deficiency issued October 14, 1981 accordingly.

DATED: Albany, New York

JAN 18 1985

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER

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STATE OF NEW YORK
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MPUS
12227

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Mix 'N' Match of Miami, Inc.
112 W. 34th St.
New York, NY 10001

CERTIFIED
470 316 452
MAIL

RECEIVED
JAN 24 1985
TAX APPEALS BUREAU

FORWARDED

FORWARDED

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

January 18, 1985

Mix 'N' Match of Miami, Inc.
112 W. 34th St.
New York, NY 10001

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Harry Wasserman
Weinick, Sanders & Co.
1515 Broadway
New York, NY 10036
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition of MIX 'N' MATCH OF MIAMI, INC. for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Fiscal Years Ended January 31, 1979 and January 31, 1980.	DECISION

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5. Periodically, petitioner found it necessary to borrow money to meet current expenses and make seasonal purchases. Whenever petitioner needed a loan, Roanna would borrow the money from a bank and then relend the money to petitioner. This procedure was followed because Roanna had previously set up cross corporate guarantees and various types of legal documentation with the bank to establish an efficient lending mechanism. The bank would have been willing to lend the money directly to petitioner; however, for the sake of convenience and efficiency, Roanna did the borrowing and acted as a conduit for the borrowed funds. The bank discounted all its loans to Roanna; that is, the bank charged the interest on the loans in advance and credited Roanna with the net amount. Roanna passed the net amount through to petitioner and charged the discount amount to petitioner which repaid the discount charge to Roanna so that Roanna could maintain its zero profit and loss balance. The discount charge paid to Roanna was taken as a deduction on petitioner's Federal corporation tax return for each of the years in issue. Petitioner did not add back 90 percent of such interest payments to its entire net income since it was merely using Roanna as a conduit for transfer of the borrowed funds. Petitioner was not undercapitalized when it received the loans and the bank was not an entity related to either Roanna or petitioner. The loans were carried on Roanna's books as loans receivable from petitioner and were carried on petitioner's books as loans payable.

6. During the years in issue, petitioner maintained no showrooms for its apparel line and had no employees other than a warehouse manager in Florida for a portion of 1978. Lassie maintained a showroom in New York City and incurred all expenses connected with its operation. Lassie also employed its own sales personnel. All of the sales personnel at the New York showroom were employed by Lassie and were enrolled in Lassie's pension plan. Lassie withheld all federal and state taxes and paid social security and unemployment insurance for the salespersons. Lassie's vice president for sales, Harold Maslin, supervised the sales personnel at the New York showroom. Virtually all of Lassie's and petitioner's sales were conducted with customers who visted the showroom. When a customer wished to see petitioner's line of apparel, Mr. Maslin would direct several of Lassie's salespersons to show the clothing to the customer. Three salesmen, in particular, were utilized for this purpose when required. Generally, the salesmen spent 70 percent of their time showing the Lassie line and 30 percent showing petitioner's line.

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CONCLUSIONS OF LAW

A. That section 208.9(b)(5) of the Tax Law provides, in pertinent part:

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(i) up to an amount not exceeding one thousand dollars,

(ii) in full to the extent that it relates to bonds or other evidences of indebtedness issued, with stock, pursuant to a bona fide plan of reorganization, to persons who, prior to such reorganization, were bona fide creditors of the corporation or its predecessors, but were not stockholders or shareholders thereof,

(iii) in full where the investment allocation percentage is applied to entire net income, and

(iv) in full to the extent that it is paid to a federally licensed small business investment company;...".

B. That the modification set forth in section 208.9(b)(5) disallows 90 percent of a corporation's Federal deduction for interest paid or accrued on indebtedness to a shareholder owning more than 5 percent of the stock of the taxpayer. The only exceptions to this modification are those situations provided for in clauses (i) through (iv) of section 208.9(b)(5). Nowhere in the law or regulations is there a provision for an exception to the aforesaid modification for a corporate stockholder which borrows money and acts as a conduit in relending the money to its subsidiary. The Audit Division, however, has, for a number of years, been following a policy whereby, under certain conditions, if a stockholder of a corporation borrows money from an unrelated source, and then lends the borrowed funds to such corporation, the interest paid to such stockholder by the corporation is deemed to have actually been paid to the stockholder merely as a conduit, and the provisions of section

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DATED: Albany, New York

JAN 18 1985

STATE TAX COMMISSION

PRESIDENT

COMMISSIONER

COMMISSIONER